VZCZCXRO8564
OO RUEHLH RUEHPW
DE RUEHLH #0020/01 0390620
ZNR UUUUU ZZH
O 080620Z FEB 10
FM AMCONSUL LAHORE
TO RUEHC/SECSTATE WASHDC IMMEDIATE 4305
INFO RUEHIL/AMEMBASSY ISLAMABAD IMMEDIATE 5003
RUEHBUL/AMEMBASSY KABUL IMMEDIATE 0544
RUEHLO/AMEMBASSY LONDON PRIORITY 0242
RUEHNE/AMEMBASSY NEW DELHI PRIORITY 0924
RUEHKP/AMCONSUL KARACHI PRIORITY 2207
RUEHPW/AMCONSUL PESHAWAR PRIORITY 1885
RHMFISS/CDR USCENTCOM MACDILL AFB FL
RUEAIIA/CIA WASHINGTON DC
RUEATRS/DEPT OF TREASURY WASHINGTON DC
RHEHAAA/NSC WASHINGTON DC
RUEKJCS/SECDEF WASHINGTON DC
RUMICEA/USCENTCOM INTEL CEN MACDILL AFB FL
RUEHLH/AMCONSUL LAHORE 5473

UNCLAS SECTION 01 OF 03 LAHORE 000020

SENSITIVE
SIPDIS

E.O. 12958: N/A
TAGS: ECON EAID EFIN EINV PGOV PREL PK
SUBJECT: PUNJAB'S DEFICIT SPENDING POSES CHALLENGES FOR NEXT IMF REVIEW

REF: 09 LAHORE 143

¶1. (SBU) SUMMARY: An August 2009 deal to finance Punjab province's deficit received sudden attention from the media in January, despite the absence of new issues arising from that deal - yet. The size of Punjab's growing deficit, however, raises concerns about the next review of Pakistan's finances under the IMF Stand-by Arrangement (SBA). Punjab's fiscal year (FY) 2008-2009 shortfall of $600 million seriously jeopardized Pakistan's compliance with the IMF SBA at the time. The provincial deficit this year could top $800 million. The province's FY 2009-2010 budget calls for robust spending increases, while assuming a correspondingly significant rise in revenue; however, revenues are falling well short of budget plans, particularly income from taxes. Punjab is cutting some expenditures, but actually increasing others. If provincial and federal authorities maintain overly optimistic revenue projections, Punjab could post another substantial, unfunded deficit at the end of FY 2009-2010. END SUMMARY.

- - -
MEDIA SEES NEW CONTROVERSY IN OLD FINANCIAL DEAL
- - -

¶2. (SBU) For three consecutive days starting from January 7, the media reported an alleged conflict in President Zardari's cabinet over a Government of Pakistan (GOP) letter to the IMF announcing a debt financing scheme between the Government of Punjab and the State Bank of Pakistan (SBP). The nationalist English daily "The Nation" carried an article claiming that Finance Minister Shaukat Tarin approved the deal without informing Prime Minister Gilani or President Zardari, and that Zardari was "astonished" and unhappy about being caught unaware. The same article noted that the Prime Minister's secretariat vigorously denied any such conflict between Tarin, Gilani, and Zardari. Although the GOP notice to the IMF was new, it was describing an agreement negotiated between the provincial government and SBP back in August 2009 after the close of FY 2008-2009, according to contacts in both the provincial and federal government.

- - -
PUNJAB'S FISCAL YEAR 2008-2009 YEAR END DEBT
- - -

¶3. (SBU) At the end of the last Pakistani fiscal year, June 30, 2009, Punjab had a substantial "overdraft" or short term line of

credit (LoC) with the SBP. The LoC is a routine cash-flow management facility, typically paid off upon receipt of revenues from the central government. Revenue from the central government accounts for approximately 85 percent of provincial government income. After fiscal year-end revenue reconciliation, Punjab still had an outstanding balance of over $600 million. The debt stood as unfinanced deficit spending. Apprehensive about fiscal space for Punjab to start FY 2009-2010, the SBP agreed to convert the balance into a four-year, low interest loan. (Note: The size of Punjab's deficit raised serious concerns during a subsequent IMF review of Pakistan's finances. End note.)

¶4. (SBU) Punjab Finance Secretary Tariq Mahmood Pasha claimed to EconOff on January 21 that Punjab's FY 08-09 year-end deficit came as a surprise. He asserted that right up to June 2009, federal officials were projecting robust revenues for Punjab. In the end, federal receipts were $393 million short of expectations. Pasha said that Punjab was also missing $48 million in delayed hydroelectric power profits and over $155 million from the aborted effort to privatize the Bank of Punjab. Bank of Punjab shares lost over 90 percent of their value in a matter of weeks as the bank and its former chief became engulfed in a massive fraud scandal, scuttling privatization plans. Pasha was puzzled by the recent media frenzy. He chalked it up to "politics," but also worried about the "misperception" that the province was "bankrupt" in the middle of the current fiscal year.

- - -
IMPOSING FISCAL DISCIPLINE: A NEW CAP ON PROVINCIAL BORROWING
- - -

¶5. (SBU) Converting Punjab's overdraft (and guaranteeing Balochistan province's LoC balance) was tied to an agreement between the GOP and the IMF to implement a new cap on all provincial LoCs, according to Pasha. The cap is to equal six week's worth of salary and pension obligations; as much as $321 million is available to Punjab. The cap was intended to impose a measure of fiscal discipline and help Pakistan meet IMF's deficit target of 4.9 percent of GDP, currently estimated at $8.7 billion. Pasha said the province was routinely running an outstanding balance of roughly $202 million for one month's total of salaries and pensions, before central government revenue was received to pay it off. The LoC mechanism works exactly as planned, and Pasha is satisfied that there is no cash flow problem. Punjab has also been making its regular monthly payments on the 2009 loan deal, over $12 million per month.

- - -
BUT PUNJAB IS STILL RUNNING A UP A LARGE DEFICIT
- - -

¶6. (SBU) Pasha's confidence about cash-flow notwithstanding, public records from the SPB and Punjab Finance Department indicate that Punjab has a substantial deficit, with no apparent financing in place to cover it. The SPB first quarterly report shows the province with a $377 million shortfall. The report states, "Punjab experienced enormous deterioration in the overall balance, turning from surplus into deficit." It was the only province with a deficit. Punjab is not using the SBP overdraft to pay its bills, so it must rely on commercial loans, budgetary support from the international donor community, or possibly borrowing from other government accounts. A 2005 World Bank report observed that Punjab has history of borrowing out of the retirement system (called the General Provident Fund) to help cover current account expenses.

¶7. (SBU) Punjab's FY 2009-2010 budget was unrealistic from the beginning (ref A). It called for substantial increases in spending, supported by a significant rise in revenues, plus an $825 million deficit that the federal government could never afford to support under the IMF Stand-by Arrangement. The new overdraft account limit of $321 million appears to signal the

federal government's tolerance level for the provincial deficit.

- - -
ROBBING DEVELOPMENT TO PAY EXPENSES, AND STILL FALLING SHORT
- - -

¶8. (U) The Punjab budget called for a 14 percent increase ($457 million) in current account expenditure, and spending has been right on plan through the first five months of the year according to Finance Department data. Development expenditure has been reduced to 55 percent of budgeted outlays through November, shaving $416 million off of the spending plan over five months. The provincial and federal governments frequently cut development funding to help cover current expense deficits, and if the revenue budget was accurate, Punjab would be in good condition.

¶9. (U) Unfortunately, both federal transfers and provincially-generated revenues have been significantly below Punjab's ambitious expectations. Punjab Finance Department reports show provincial receipts through the first five months of the current fiscal year are $163 million below plan. At that pace, annualized provincial revenue would be $392 million below budget. Federal transfers, which account for 85 percent of provincial income, look similarly weak. SPB reports show first quarter transfers to Punjab were 11 percent below the provincial forecast, at $879 million. Federal transfers to Punjab could be as much as $438 million below the province's plan by the end of the fiscal year. Combined with the province's own revenue gap, Punjab's annual income could well be $830 million below budget.

- - -
PUNJAB HOPES TO IMPROVE TAXES AND COLLECTION, SUPPORTS VAT
- - -

¶10. (SBU) Pasha said Punjab was looking for possible new sources of income, but when pressed for details on timing and amounts,

neither he nor his staff could offer specifics. He said the provincial government is considering floating bonds, launching a Real Estate Investment Trust (REIT), and even securing commercially available financing. (Note: These same options have been under consideration at least as far back as a 2003 World Bank examination of Punjab's debt burden. Progress has been slow because of the province's high existing debt burden, narrow sources of revenue, and limited financial management talent, combined with Pakistan's political instability in general. End Note.)

¶11. (SBU) Provincial Additional Finance Secretary Zarak Mirza said that an overhaul of property taxation was almost complete, but he was not sure when it could be approved by the Chief Minister. Mirza also noted that the Punjab Resource Management Program (PRMP) was putting the final touches on a finance department capacity-building roadmap that would help improve tax collection in the future. He went on to ask for USG assistance with implementing the PRMP plan. Finance department leaders were also supportive of moving to a federal Value Added Tax (VAT), as they expected it to enhance provincial income.

¶12. (SBU) COMMENT: Recent media attention on Punjab's deficit financing may be just highlighting old news, but it does suggest a potentially serious problem for future IMF SBA reviews. Punjab officials could or should have recognized revenue problems in fiscal year 2008-2009, well before the June 2009 "surprise." With increased expenses, flat revenue, and a challenging economic climate, the province appears to be facing a similar fiscal problem for FY 2009-2010. It is highly unlikely that their proposals for increasing income, with less than five months left in the current fiscal year, will be enough to meet the shortfall. The federal government seems prepared to finance a deficit up to $321 million, but Punjab exceeded that after just three months. Unless provincial spending is sharply reduced, Punjab's deficit could be as much as $800 million at

the end of June 2010, with serious repercussions for future IMF
SBA reviews. END COMMENT.
CONROY